April 17, 2018

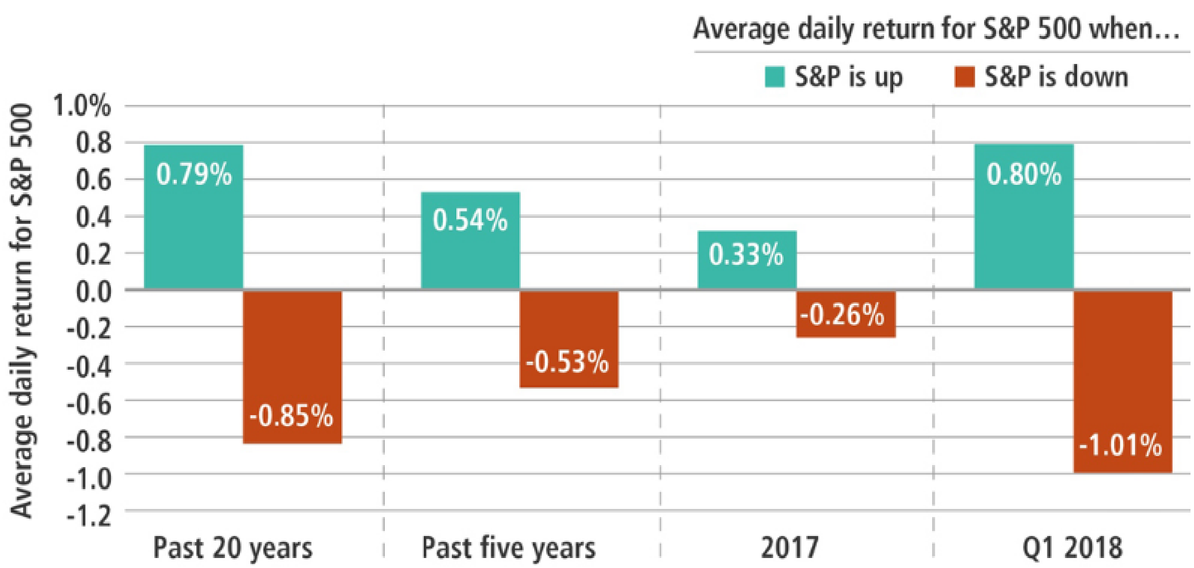
Risk Cuts Two Ways

Volatility Returns to Markets

The US stock market began 2018 with a roar, with the S&P 500 gaining over 7% while climbing to an all-time high on 1/26. Investor confidence was fueled by a steadily strengthening economy, rapidly growing company earnings, and a seemingly relentless market climb – January marked a record-tying 15th consecutive month of higher US stock prices. After peaking in late January, the US stock market entered a period of considerable volatility (at least by recent standards), giving up the month's gains and ending the first quarter with a modest loss of close to 1%. Almost in tandem, international equity markets gave up significant ground after a strong rally to start the year.

While recent market moves have been unsettling for investors, a bit of perspective is in order. The S&P correction from its January high to its February low of 10% was considerably less than the long-term ***average*** intra-year correction. Additionally, as depicted in Graph 1, stock volatility has simply returned to more typical levels, after a period of unusual calm in recent quarters. In other words, the recent market turmoil is entirely normal, and probably overdue.

Graph 1



Source: Bloomberg

Market pundits always offer reasons, generally in hindsight, to explain the causes of the marginal imbalance of buyers and sellers that drive market price moves. This time is no exception: the reasons most often cited for the market correction and increase in volatility have been fears of a global trade conflict, and concerns about rising interest rates and inflation. Other causes cited have been an expensive technology sector, and ubiquitous geopolitical concerns.

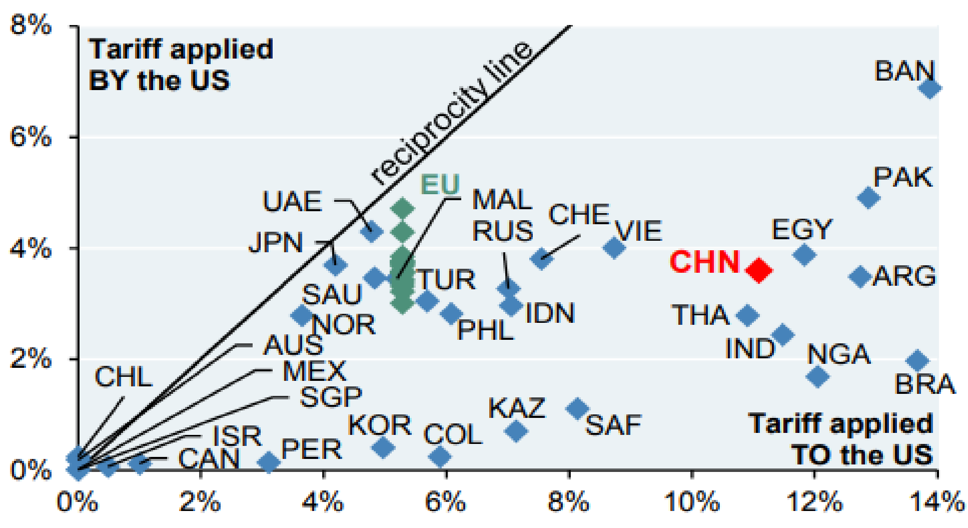
When managing investment portfolios it is critically important to understand that risks must be assessed from multiple perspectives, and that most issues involve both potential upside and downside outcomes, each with associated probabilities. A successful investment strategy requires dispassionate analysis, and an allowance for a range of outcomes. Such an approach can be increasingly difficult against the backdrop of today's polarized political environment, where assessments are often made in a binary fashion. Market outcomes rarely conform neatly to such binary analysis.

Trade and Interest Rates

The Trump administration has taken an aggressive approach to international trade, claiming unfair trade practices by multiple counterparties (particularly Mexico and China) and demanding a renegotiation of current arrangements and the institution of tariffs on various imports to the US. This approach, and China's quick threats of retaliation, have led to market concerns about a global trade war which, if realized, would almost surely have a very negative effect on the global economy and stock markets.

It's not necessary to debate the advisability of the administration's approach to recognize that there are important elements of both fact and fiction in much of the President's trade rhetoric. It's true that China has indeed long engaged in unfair trade practices, both in terms of a lack of intellectual property protections and an asymmetric tariff regime with the US (as have other countries, as shown in Graph 2). What is false are the assertions that Mexico engages in such practices, and that trade deficits are evidence of such, or constitute economic "losses" to the US.

Graph 2



Source: WTO, World Bank, JPMAM

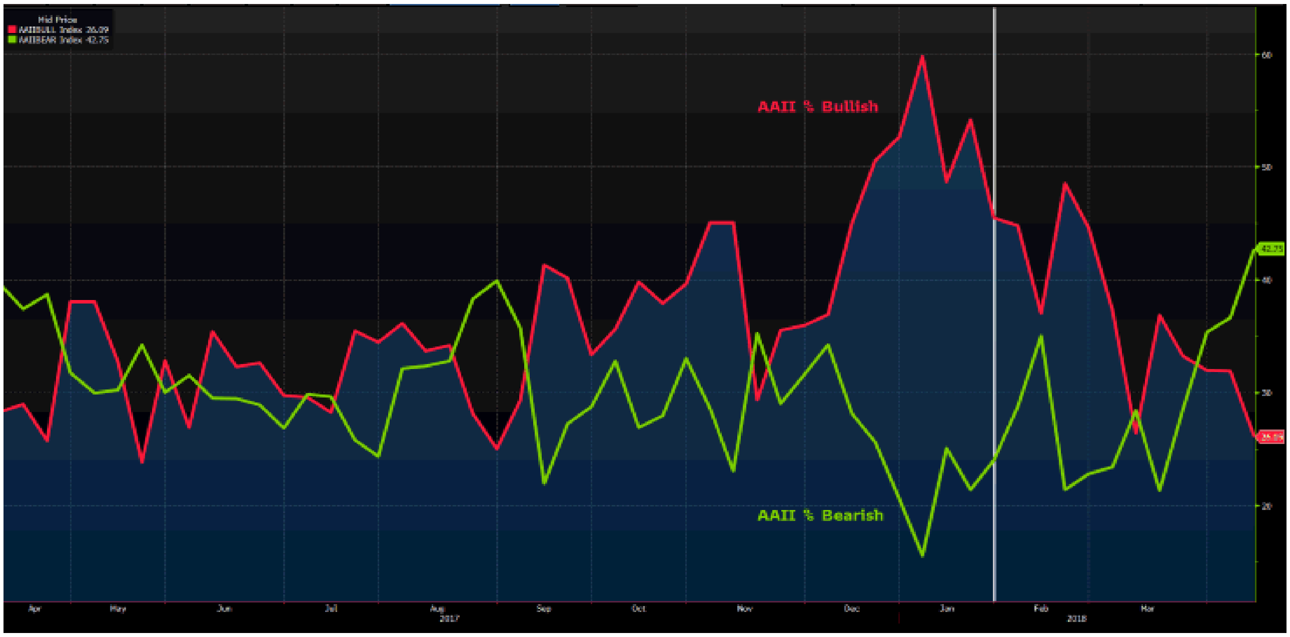
From an investment perspective, it's important to understand that the administration's approach (while risky, and perhaps ill-advised) presents not only the downside risk of a trade conflict, but also upside "risk" in the form of potentially much better trade deals and, as markets increasingly price in fears of trade disruption, a relief rally should such fears not materialize. Indeed, as of this writing, reports have emerged that the administration is considering entry into the Trans Pacific Partnership (TPP), from which it withdrew immediately after the 2017 inauguration. Should this occur, it would be a very positive development. At SFA, it's our job to consider both potential outcomes in our portfolio construction and risk management.

In recent weeks, markets have also adjusted to higher interest rates, and an expectation of an increased pace of future rate hikes. Concerns were fanned by a more "hawkish" tone from Federal Reserve Bank officials, including new Fed Chairman Powell who expressed confidence in the economy, and indicated that the Fed will likely continue raising rates to keep inflation under control. Certainly, higher interest rates mean higher financing costs, and as such represent a headwind for financial assets. Nevertheless, as we have often noted, higher interest rates tend to be the result of a stronger economy, and unless rates rise very rapidly or to excessive levels, an accelerating economy will likely dominate rate increases and support equity markets. US companies are beginning to announce first quarter (Q1) 2018 earnings, which are expected to post large increases (of about 17%) relative to Q1 2017. Should those expectations be met, higher rates should fade as an immediate concern, and the risk will increasingly be to the upside.

Investor Sentiment

We regularly monitor investor sentiment, and take note when there appears to be excessive enthusiasm or pessimism. Extremes in aggregate sentiment can be a valuable "counter-indicator," with bullishness rampant near market tops (as investors forget caution), and bearishness pervasive near market bottoms (as fear limits the ability to identify opportunity). Individual investor sentiment has historically been a particularly good counter-indicator as, unfortunately, emotions have led to a propensity to sell low and buy high. Graph 3 depicts the American Association of Individual Investors (AAII) bullish investor % (red) against the bearish % (green), and shows an excess of positive sentiment just before the January market peak (marked by the vertical white line), and a current excess of bearish sentiment.

Graph 3



Source: Bloomberg

The nature of investing is one of taking and managing risk, with a recognition of the potential for both upside and downside risk. The most important element of a successful investment strategy involves adopting a risk profile suited to one's personal situation, and sticking with it throughout market cycles, regardless of news headlines. Not doing so introduces risk to the attainment of an investor's long-term objectives. Thank you for your trust, and please don't hesitate to call a SFA team member to arrange a discussion to review how your current risk profile suits your needs and objectives.

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